



## Comparing Nonprofit and Cooperative Entities

Nonprofit or cooperative? Questions about the differences between these two types of legal entities are often part of early cooperative development discussions.

These questions may come up when groups are looking at start-up financing. Grants and donations might be considered as a source of low or no-risk seed capital, and an entity must have a nonprofit tax-exempt status to be eligible. Future tax liabilities of the new organization also may be a concern.

Other questions might be related to the governance of the new entity. Groups that are interested in democratic, member-based governance will want to know whether these goals fit with the legal requirements for these entity types.

Understanding the differences between a nonprofit and a cooperative can be confusing because some of the terminology is similar. A nonprofit organization that is tax-exempt appears similar to a cooperative that operates on “not-for-profit” basis and doesn’t pay taxes on some of its earnings. Both nonprofits and cooperatives can have members and use member-based governance.

However, though terminology may be similar, there are important differences between the two types of organizations that should be understood before making a final decision on incorporation status.

### **Tax-Exempt Status**

An organization’s tax-exempt status is based on two independent but related characteristics: its *incorporation status*, which is determined on the state level; and its federal *tax status*, which is determined by the Internal Revenue Service (IRS).

### *Incorporation Status*

Like any other business entity, both nonprofit and cooperative organizations incorporate under state statutes. These state statutes outline the legal requirements for the entity’s governance and operation.

State statutes are not uniform, and entity types and requirements can vary significantly from state to state. Typically the incorporated entity is a corporation that has a legal identity independent of any individual participant or owner.

In Wisconsin, nonprofit organizations usually incorporate as a nonstock corporation under Chapter 181 of the state statutes. While this statute does not prohibit business activities, it requires that any profits from

business activity must be retained by the organization to carry out its goals; profits or assets cannot be distributed to individuals.

In contrast, the two cooperative statutes in Wisconsin are types of business statutes that provide guidelines for profit and asset distribution. Cooperative profit distribution to the member-owners is based on patronage, or how much business a patron conducted with the cooperative.

Furthermore, a cooperative may issue stock to capitalize its activities and make distributions to stockholders or other investors in specific situations. In the case of dissolution, assets may be distributed to members as described in the articles and bylaws.

In other states, cooperative incorporation options may be limited due to other restrictions in the cooperative statute. For instance, some state cooperative statutes limit cooperative incorporation to organizations that provide agricultural services to support producers.

### *Tax Status*

A tax-exempt organization does not pay federal income tax, nor, in some cases, other types of state and employment taxes.

Federal tax-exempt status is granted by the IRS to a variety of organizational types. Nonprofit organizations that are exclusively organized and operated for charitable or educational purposes as described in sections 501(c)(1) – (28) of the tax code are tax-exempt. The federal tax code requirements are specific about how a particular entity must operate to carry out this exempt purpose.

Tax exemption is granted by the IRS through its own application process; it is not automatically granted on the basis of (non-uniform) state incorporation status.

Cooperatives, however, are eligible for a different type of federal tax exemption. “Operating on a cooperative basis” means that the business operates to deliver services at cost rather than to produce a return to investors, and passes any surplus earnings to patrons.

Therefore the IRS exempts from corporate taxation all cooperative profits that are distributed to members or patrons on the basis of use. Whether these patronage dividends are taxable as income at the member level depends on the type of cooperative service being provided.

Again, because state incorporation statutes are not uniform, the IRS does not grant cooperative tax advantage solely on the basis of incorporation status but requires other documentation.

## **Member Governance**

Cooperatives in Wisconsin are owned and controlled by their members, typically on a one-member, one-vote basis. Members elect a board of directors from the membership. The board oversees management, and it develops the long-range business strategies that both ensure the economic health of the cooperative and meet the needs of the membership.

Wisconsin nonprofits incorporated as nonstock corporations may have members, but it is not required. The articles of incorporation or organizational bylaws can specify a nonprofit's membership types and requirements. Articles or bylaws may also describe whether members elect the board of directors, whether the vote is on a one-member, one-vote basis, and whether the board must be elected from the membership.

## **Considering Cooperative and Nonprofit Incorporation Options**

Groups often focus on making a business structure decision very early in the development process. However, an understanding of the goals of the organization, and how it will meet the needs of the potential membership base, will support better decision-making about financing and organizational structure.

Cooperative start-up groups might consider whether their long-term purpose fits the nonprofit, non-ownership structure. While cooperatives are sometimes described as operating on a "not-for-profit" basis, this reflects the goal of providing member services at cost. "At-cost" does not preclude the cooperative operation from generating profit, which provides a buffer against future losses and a source for the capital reinvestments necessary for any healthy business.

In a cooperative business structure, these profits, as well as any assets, could be distributed to the members at some point in the future because they have ownership rights. In a nonprofit structure, surplus or asset distribution to members is not allowed.

Given these future considerations, cooperative start-up groups might consider financing alternatives that do not depend on a nonprofit tax-exempt status.

If the nonprofit, tax-exempt status reflects the organizational mission, and future distributions are not a concern, a nonprofit incorporation option might be appropriate. Under Wisconsin law, this does not preclude the organization setting up a membership-based governance structure similar to that described under cooperative statutes.

The incorporation decision may take longer as the group works through these considerations, but the outcome will support rather than constrain the organization's future activities.

Getting professional legal and accounting advice during this process is advisable. However, the advice can be more focused on the particulars of the situation if the group has an understanding of the difference between the two types of structures and the goals of the entity being organized.



## FAQs: Comparing Nonprofits and Cooperatives in Wisconsin

*We're in the process of organizing our business as a co-op, and want to apply for a grant to fund a feasibility study. Should we try to incorporate as a nonprofit so we can receive grant funds?*

Grant opportunities during the development phase shouldn't drive incorporation decisions. A cooperative business that is incorporated under the cooperative business statute establishes ownership rights for its members, who may receive distributions from the cooperative.

Some grant programs are specifically designed for business start-ups and do not require tax-exempt status. If a grant program seems appropriate but funds can only go to tax-exempt organizations, then identifying an intermediary tax-exempt organization that could act as fiscal agent might be an option. The organization as fiscal agent could receive the grant, and responsibility for administering the grant funds.

*Our group wants to create an organization to provide member services which could be classified as charitable or educational. We would like to set up some requirements for membership, and use a democratic process to control the direction and priorities of our organization. Should we incorporate as a co-op?*

The group might consider incorporating as a membership-based nonprofit entity under Chapter 181, the non-stock corporation statute. The bylaws or articles of incorporation can specify membership requirements, and make provisions for electing the board of directors from and by the membership.

Membership requirements could include fees to help cover the cost of providing services. This would not preclude the organization from also looking at grants and donations to support its tax-exempt purpose.

Federal tax-exempt status based on the organization's charitable or educational purpose is not determined by the statute that the organization has incorporated under. There is a separate process for applying to the federal government for this federal tax-exempt status.

It is important to keep in mind that as a nonprofit, tax exempt organization, there are no owners. Distribution of any surplus funds cannot be made to members, and on dissolution the organization's assets must go to another nonprofit entity.

*If we want to operate our co-op business to just cover the costs and pay a living wage, should we incorporate as a nonprofit?*

Some nonprofits run subsidiary business activities to support their broader tax-exempt mission. If the earnings are through business activity that is related to the exempt purpose, those earnings also may be tax-exempt. Factors such as the activity's level of earnings, and similarity to other commercial enterprises may come in to play, and may threaten the tax-exempt status of the organization.

If the business is owned by a group that may want to receive a share of the profits at time in the future, or would want a share of the assets on dissolution, then it might consider incorporating as a cooperative. Even operating "at-cost" requires earning some financial surplus, which are used to buffer the inevitable ups and downs of any business. Some profit margin is a source for capital reinvestments necessary for any healthy business. In a cooperative, any surplus margins can be also be distributed back to member owners on the basis of patronage.

**This information is not intended to take the place of legal advice. A knowledgeable attorney should be consulted in making final decisions about incorporation.**